Technical note transmitted by the Bank of Italy to the Committee of Enquiry of the Regional Council of Veneto

15 April 2016

This note is written in response to the requests formulated by the Committee of Enquiry set up by the Veneto Regional Council to investigate events involving the regional banking system, with special reference to Banca Popolare di Vicenza (BPV) and Veneto Banca (VB).

Events at the two former cooperative (*popolari)* banks came to the public's attention when news broke of the investigation launched by the public prosecutor's office. In the debate that ensued, the Bank of Italy's actions were repeatedly called into question, often on the strength of mistaken premises or fundamental misunderstandings. The Bank of Italy refrained from comment out of respect for the investigating magistrates, with whom it has been actively cooperating for months. While it cannot enter into the substantive issues forming the basis of the enquiry, in respect of which it is bound by professional secrecy obligations, in view of the request for information from the Committee the Bank of Italy can nonetheless provide the following indications to shed greater light on some matters pertaining to the supervision of BPV and VB.

By way of introduction, it appears appropriate to focus on two issues which, though at different times and to differing extents, arose at both banks and which have to do with their shared condition of being unlisted cooperative banks. In particular, how share prices were determined and the practice of disbursing loans to customers against purchases of the banks' own shares.

Regarding the former, Italy's Civil Code[1] assigns responsibility for setting the price of shares in unlisted cooperative banks to the general shareholders' meeting, which votes on a proposal by the Board of Directors. The Bank of Italy has no direct power to determine share prices and accordingly has not adopted any specific measures on this issue. It nonetheless repeatedly called on both banks to establish adequate procedures and objective criteria for setting the price of their shares, without prejudice to the responsibility of the management boards, and in particular of the shareholders' meeting, to determine that price.

[1] Article 2528.

The practice of raising funds (and making capital increases) by disbursing loans to customers against purchases of the banks' own shares calls for an important clarification: for civil law purposes, loans granted by banks to customers against purchases of shares issued by the same banks are lawful subject to the conditions set out in Article 2358 of the Civil Code. For prudential purposes, however, the sector's laws provide that shares purchased in this way cannot be included in own funds. The reason for this is clear. The rules consider this capital as an initial buffer for absorbing any losses; it must therefore comprise genuine resources, not those at high risk of being wiped out by unpaid loans. It should also be borne in mind that links between purchases of shares and disbursements of loans are not detectable in off-site supervisory activities. Only an on-site inspection, and a targeted one at that, can identify this practice, as in fact happened in the case of both banks.

To properly comprehend the interventions described below, it is worth recalling that with the launch of the Single Supervisory Mechanism on 4 November 2014, the ECB, in conjunction with the National Competent Authorities (in Italy, the Bank of Italy), assumed responsibility for the supervision of relevant banking groups identified in accordance with a specific methodology. At the time of writing there are 14 such banks in Italy, including the Veneto Banca and Banca Popolare di Vicenza groups. The supervisory activities of the Joint Supervisory Team, which comprises staff from the ECB and Bank of Italy, are the main vehicle for cooperation between these two authorities and the first point of reference for banks.

The two situations at the banks referred to in the Committee's request are now illustrated separately below.

Veneto Banca

In the case of VB the first evident signs of a technical deterioration emerged following an inspection conducted in 2013 by the Bank of Italy. Among other things, the Bank's inspectors uncovered the practice of disbursing 'loans-for-shares', ascertaining that VB had failed to deduct from own funds the amounts raised against loans granted by the bank to subscribers of its own shares.

Pursuant to Article 53(3)(b) of Legislative Decree 385/93, the Bank of Italy sent a letter to Veneto Banca's Board of Directors ('intervention letter') requesting that the management bodies convene and put on the agenda the examination and discussion of the overall situation based on the inspection's findings and on the contents of the letter, and make the attendant urgent decisions. VB was called on to radically overhaul its governance arrangements, by adopting incisive and timely measures that would represent a clean break with the past, and by taking remedial action designed, among other things, to strengthen its capital ratios. In view of the problems that emerged, the Bank of Italy requested VB to plan a merger with another intermediary of adequate standing at the earliest opportunity, something that would enable it to strategically reposition itself and repair its balance sheet in the interest of ensuring proper governance. Given the findings of the inspection, the Bank of Italy requested that in any event the bank proceed to replace its management and control bodies *in toto*.[2]

In light of the findings of the inspection, in August 2014 the Bank of Italy levied fines of over €2.7 million on VB's corporate executives.

In its counter-arguments presented as part of the sanction proceedings, VB admitted to the existence of 'loans for shares' as uncovered by the inspections, despite significantly downplaying its extent and accordingly only partially complying with the requested deductions from own funds, though, had it deducted the full amount identified, capital levels would not have fallen below the regulatory minimums then in force.

Taking into account the bank's responses and planned corrective measures, which appeared poorly suited to delivering the decisive turnaround in corporate governance requested, in January and March 2014 the Bank of Italy again called on VB to implement the requests made in the intervention letter, including those to replace the management and control bodies *in toto* and rectify the own funds ratios in accordance with the inspections' findings. In the letter sent in March, VB was also asked to read out to the general shareholders' meeting called to approve the 2013 accounts the official requests for action sent by the Bank of Italy, to ensure full awareness on the part of shareholders of the bank's situation and of the supervisory measures taken.

[2] At that time the Bank of Italy was not empowered to remove top executives even when their continued tenure in office jeopardized sound and prudent management. This power, which was called for on several occasions by the Bank, was recently introduced into national law by Legislative Decree 72/2015.

In April 2014 VB appointed a new Board of Directors and Board of Statutory Auditors; however, no actual, radical overhaul of governance was undertaken, given that the then CEO was later confirmed as Director General, maintaining a broad array of powers and mandates, and in the absence of the CEO, *de facto* representing the link between the Bank's operational structures and its management bodies.

Again in April 2014 the comprehensive assessment commenced,[3] occupying the Supervisory Authorities up to the publication of the results in October of the same year. VB was assessed in 2014. Upon its completion, a targeted inspection of governance, remuneration schemes and internal controls was immediately scheduled to take place within the first six months of 2015, to follow up on the findings that emerged in the previous inspection; a specific probe was also conducted into the practice of disbursing loans to customers against purchases of the banks' own shares.

The on-site inspection brought to light the repeated practice of banks disbursing loans against share purchases without making the requisite deductions from own funds. This had a negative impact on the bank's capital profile amounting to around €300 million, as recorded in its quarterly report to 30 September and its 2015 financial statement; a further €56 million in deductions emerged following the analyses carried out by internal auditors at the request of the Bank of Italy, covering the positions that had not been examined during the sampling done by the inspectors. The bank's financial situation was also affected by the deterioration of its loan portfolio that led to the recording of more than €700 million worth of loan loss adjustments in the 2015 balance sheet. The need to exclude 'loans for shares' from own funds (and to include further losses that emerged) obliged the bank to strengthen its capital ratios. The Bank of Italy requested VB to restore compliance with the prudential capital requirements, launch its own strategic plan, rapidly identify measures to cope with any unforeseen liquidity needs, and strengthen its organizational structures, processes, procedures and strategies related to its internal auditing functions.[4]

Since August 2015 the CEO and the most of the top management have been replaced. In October 2015, following the resignation of the previous incumbents, the bank appointed a new President of the Board of Directors and in December a new Vice President of the Board. A new €1 billion capital strengthening plan was drawn up, the positive outcome of which is ensured by a guarantee

[3] In the run-up to the launch of the SSM, the ECB and national competent supervisory authorities conducted a comprehensive assessment of the balance sheets of the relevant banking groups, comprising an asset quality review and stress test.

[4] With reference to the irregularities that emerged during the on-site inspection, the Bank of Italy and the ECB are examining the findings of the inspection to assess whether to start sanction procedures.

consortium; there is also a plan to radically overhaul the corporate governance structures, which began recently when VB was transformed into a joint stock company and will reach completion with its listing on Borsa Italiana. Overall, this set of initiatives could re-establish compliance with the capital requirements imposed by the supervisory authorities and make good most of the shortcomings related to the management of the bank's shares.

It is worth underlining that the transformation of VB into a joint stock company was decided within the framework of the legislative provisions that launched a reform process proposed several times by the Bank of Italy and which could no longer be deferred (Decree Law 3/2015, converted into Law 33/2015). As recalled on a number of occasions,[5] the weaknesses of the cooperative (*popolari*) banks' governance arrangements are a specific source of vulnerability within the Italian banking system, which have long limited their capacity to turn to the capital markets to obtain adequate capitalization.

For VB, moreover, the transition to a joint stock company is part of the reform of the governance structure that also entails listing on the stock exchange. These are changes that considerably expand the bank's capacity to access the capital markets; they will help resolve the problems that characterize the current process for determining the share price, which the law assigns to the shareholders' meeting. The listing will also provide a liquidity guarantee for shareholders who want to dispose of the shares in their possession.

From a prudential supervision standpoint, the entire project marks a very important step forward for the bank and its shareholders in that it allows adequate capital ratios to be re-established and will lead to a radical overhaul of the governance structure.

Banca Popolare di Vicenza

In the case of BPV, the latest developments in supervisory action have been focused on the bank's trading in own shares. In 2013, in particular, a number of supervisory interventions were made (by letter and in the course of meetings) to urge the bank to comply in full with the prudential limits in force at the time (prior to 2014) for buybacks of own shares, and to impress upon it the need to not generate expectations among shareholders of the certain and immediate liquidity of their holdings and guaranteed minimum returns.

[5] Testimony before the Chamber of Deputies of the Senior Deputy Governor of the Bank of Italy, Salvatore Rossi, on 17 February 2015 and of the Director General for Financial Supervision and Regulation of the Bank of Italy, Carmelo Barbagallo, on 9 December 2015.

Since the entry into force of Regulation (EU) No. 575/2013 on prudential requirements for credit institutions and investment firms, the supervisory authorities' checks on trading in own shares have assumed greater importance. Until the end of 2013 the Bank of Italy was required by law to authorize these repurchases only if they exceeded 5 per cent of the capital, but starting in January 2014 authorization was necessary in all cases. The standard for deciding whether or not to grant authorization is purely prudential: when a bank repurchases its own shares it reduces its capital and this must be carefully assessed by the Supervisory Authorities.

In the course of 2014 it emerged that BPV was buying its own shares without having first sought authorization. At that time, the Bank of Italy was engaged in the comprehensive assessment ahead of the transition to the Single Supervisory Mechanism (SSM). In agreement with the new European supervisory set-up, the Bank of Italy included among the objectives of an inspection scheduled for early 2015 a check on how the trading of own shares was conducted.

In the context of the SSM, on-site inspections by Bank of Italy staff, in addition to revealing unauthorized share buybacks by BPV, brought another problem to light, i.e. that of 'loans for shares'. In fact, the inspection revealed that BPV had failed to deduct from own funds substantial amounts raised against loans it had disbursed to subscribers of its shares, and had failed to inform the Bank of Italy.[6]

This reduced the capital by about €1 billion, which was recorded by the bank in its half-yearly report to 30 June and in its 2015 financial statement. Its financial situation was also affected by the deterioration of its loan portfolio, which led to the recording of €1.3 billion worth of loan loss provisions in the 2015 balance sheet (up 54 per cent compared with the previous year).

As soon as the first signs emerged from the on-site inspections conducted in February 2015, the Bank of Italy urged BPV to take immediate corrective action.

[6] The transactions not deducted from own funds recalled in the text should not be confused with other share subscriptions made in 2013 and 2014, and explicitly funded by the bank pursuant to the provisions of Article 2358 of the Civil Code. In taking note of the latter, the Bank of Italy had urged BPV by letter to comply with the conditions imposed under civil law, emphasizing that from a prudential standpoint the increases should only be counted towards the bank's own funds as and when the loans were reimbursed by the shareholders.

Once it had concluded its inspection, the Supervisory Authorities adopted the consequent formal decisions, obliging the bank to reconstitute its regulatory capital ratios, draw up a new industrial plan and another one to cope with any liquidity emergencies, and to strengthen its organizational structures, processes, procedures and strategies related to its internal control system.

Under the impetus of supervisory action, the top management of the BPV was replaced; the members of the Board of Directors most closely involved in the problems revealed by the inspection handed in their resignations and all those responsible for internal auditing were replaced. In line with its new industrial plan, the bank decided to undertake a general capital strengthening and radically change its corporate governance, including its transformation into a joint stock company (approved by the shareholders' meeting on 3 March 2016), a capital increase of €1.5 billion and listing on Borsa Italiana (by means of an IPO).

As already mentioned in relation to VB, this set of initiatives will, overall, considerably increase the bank's capacity to access the capital markets; they will help resolve the problems that characterize the current process for determining the share price, and will also guarantee liquidity for shareholders who want to dispose of the shares in their possession.

In the case of BPV too, this is a very important transition for the bank and its customers to make, and one which will reach its conclusion with the complete renewal of management bodies; the new Board of Directors and the new Board of Statutory Auditors will be appointed by the general shareholders' meeting following the capital increase and listing on the stock exchange.

Lastly, it should be noted that the assessments of the competent authorities – the Bank of Italy and the ECB – regarding the initiation of sanction proceedings against the bank and persons implicated in the findings of the latest inspections are still under way.